Subscription Credit Facilities: Misperceptions Remain Aplenty

December 7, 2017

Introduction

On November 15, 2017, audit, tax and consulting firm PwC published a thought leadership piece titled: "*Sub-line facilities: end of the road?*" (the "Article").[1] While the subscription credit facility ("Subscription Facility") market has become accustomed to seeing inflammatory headlines in the financial press in recent years, it is somewhat unsettling to see a thought leadership piece from the likes of PwC bear such an ominous title. PwC is an experienced, global, preeminent financial institution with countless touch points with the private equity industry. The Article's title suggests that PwC's audit or tax practices might have recent experiences or observations that support such a dire headline. Reading the article, however, that does not at all appear to be the case. Rather, the Article largely just summarizes the views articulated in recent coverage in the financial press. In fact, the Article concludes: "A major shift in the use of the facilities is unlikely." Perhaps the title of the Article could have better fit the conclusion.

Article Analysis

I. **Background**. The Article articulates the pros and cons of the use of Subscription Facilities and gives predictions for what is likely to occur in the market in the near term. The best we can tell, the Article relies on recent press reports and media publications as its primary sources, rather than the direct experiences or observations from PwC's audit and tax professionals. For example, as evidence supporting a premise that limited partners (each, an "Investor") are increasingly focused on Subscription Facilities, the Article repeats a factual example first articulated in a Private Equity International publication (the "PEI Article") in March of this year.[2] The example involves an Investor's withdrawal of a commitment to a European direct lending fund sponsored by Alcentra Limited ("Alcentra"). The Article, similar to the PEI Article, implies that an Alcentra investor withdrew its

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[1] A copy of the Article is available on PwC's website at https://www.pwc.co.uk/who-we-are/regional-sites/london/insights/basic-text-page-.html.

[2] See, "*Walking the line*", Private Equity International, Cole, Marine (March 9, 2017), available at https://www.privateequityinternational.com/walking-the-line/.

commitment based on concerns with a Subscription Facility. However, we believe the facts to be slightly different. The Investor referred to is presumably San Bernardino County Employees' Retirement Association ("SBCERA"), a municipal pension of a county in the state of California. According to the Report/Recommendation to the Investment Committee of SBCERA dated December 6, 2016 and made available to the public (the "SBCERA Report"), SBCERA initially approved an investment of $25 million in Alcentra's European Direct Lending Fund (the "Alcentra Fund"). The SBCERA Report indicates that the investment team evaluated both the levered and unlevered investment options available in the Alcentra Fund and opted for the "levered sleeve".[3] Subsequently, they reviewed the terms of the "leverage facility" the Alcentra Fund had entered and determined they were not comfortable with the terms agreed to. We believe, based on the explicit text of the SBCERA Report, how the "levered sleeve" of a debt Fund would typically be managed and what we have heard in the market anecdotally, that the concern leading to SBCERA's withdrawal related to a true leverage loan facility, not a Subscription Facility at all. Regardless, private equity funds (each, a "Fund") have raised billions and billions of dollars in 2017; why one particular Investor passes on one particular Fund is a marginal data point on which to base any overarching proposition. Meaningful trends are what matters. Besides, Alcentra has announced that the Alcentra Fund in question raised €4.3 billion in capital commitments at its final closing.[4] This suggests plenty of other Investors were perfectly happy with Alcentra's investment strategy.

II. **Detriments of Subscription Facilities Articulated in the Article**. The Article describes "[t]he case against" Subscription Facilities by highlighting three primary cons. We believe PwC was just repeating negatives articulated in various press reports over the summer rather than giving its own assessments. But when cons are listed out by bullet point without quotation or attribution, it creates an impression that PwC may endorse or agree with the negatives listed. Thus, we evaluate them below.

A. **IRR "Manipulation"**. The Article states that "[a] popular criticism of Subscription Facilities relates to manipulation of a fund's internal rate of return" ("IRR"). It is certainly true that this is a popular criticism; press reports have exaggerated the impact of Subscription Facilities on IRR throughout the past year

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3 See, AGENDA, INVESTMENT COMMITTEE, SAN BERNARDINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION (December 6, 2016), "*Report/Recommendation to the Investment Committee of San Bernardino County Employees' Retirement Association", Item 7, p.1, available at* https://services.sbcera.org/sirepub/mtgviewer.aspx?meetid=449&doctype=AGENDA

4 See, News Release, "*Alcentra Announces the Final Closure of its Second European Direct Lending Fundraising, Commitments of €4.3 bn reflects strong demand for non-bank lending to the European Market,*" (March 7, 2017), available at https://www.alcentra.com/news/news/alcentra-announces-the-final-closure-of-its-second-european-direct-lending-fundraising.pdf.

with the Financial Times going as far as labeling Subscription Facilities a "trick" to boost private equity fees.[5] But is this a valid criticism? Boston Illiquid Securities Offering Network, Inc., in a research piece titled "*Lines of Credit and their Impact on Performance Evaluation*," undertook a data analysis to test the validity of this criticism.[6] Their analysis looked at the performance of 498 buyout Funds, assuming a one-year delay from investment (each, an "Investment") acquisition to the related capital call (in each case with the deferral enabled by individual loans under hypothetical Subscription Facilities). Their analysis concluded that over the life of the sampled Funds, the median IRR boost from a Subscription Facility with a one-year clean down assumption was in the 35-45 basis points range. For the top performing Funds, the boost was 90-100 basis points.[7] For an asset class like private equity with high return targets, this impact on IRR is frankly quite modest. At such minimal levels of actual impact, characterizing Subscription Facilities as IRR "manipulation" intended to boost fees of the Fund sponsors ("General Partners") is an unfortunate characterization. There is no "manipulation" (nor the deception that the term connotes). The enhancement is small, the math creating it is simple and all of this is easily understood by Investors sophisticated enough to be investing in private equity in the first place.

B. **Investor Transfer Restrictions**. The Article lists a second downside of Subscription Facilities that "GPs can refuse to allow transfers if it decreases their borrowing base" under a Subscription Facility. It would have been very interesting if PwC had given its practical experience on this point (i.e., has PwC ever seen a General Partner prohibit an Investor transferring a Fund interest as a result of the corresponding Subscription Facility borrowing base impact?). The Article does not say. We have never seen or heard of an Investor transfer being prohibited by a Fund over Subscription Facility borrowing base implications. Perhaps, again, an articulated detriment not grounded in factual reality.

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5 See, "*Financing 'trick' boosts private equity fees*", Financial Times, Flood, Chris (October 20, 2016) ("Financial Times SCF Article"), available at https://www.ft.com/content/c5c24c58-953c-11e6-a80e-bcd69f323a8b.

6 See, "*Lines of Credit and their impact on Performance Evaluation*", CobaltGP, Boston Illiquid Securities Offering Network, Inc. (2017), available at https://pages.cobaltgp.com/acton/media/32824/how-private-equity-lines-of-credit-are-impacting-irr.

7 To be fair, the IRR boost is of course greater in the early years of a Fund's existence, diminishing over the life of a Fund.

C. **<u>Financial Crisis Analysis</u>**. Finally, and perhaps most concerning, PwC paraphrases a Financial Times article implying Subscription Facilities increase systemic risk.[8] The Article states:

> "*If there were to be a downward economic shift, this could be exacerbated if banks demand repayment and investors default on capital calls. GPs will then sell liquid assets (shares and bonds) to meet these demands, leading to further instability and the facility potentially becoming a significant risk to banks. However, such facilities are over-collateralised and issues have been resolved promptly. It is unclear if this will hold during any financial crisis.*"

This paragraph contains multiple misperceptions and ignores lessons from the most recent financial crisis. First, the Subscription Facility market is predominantly structured on a committed loan basis. Banks cannot simply demand repayment in a financial crisis. That is a factual misconception. The typical Subscription Facility would require a default prior to a bank's ability to accelerate repayment prior to maturity. Second, "GPs will then sell liquid assets (shares and bonds)"? Subscription Facilities are primarily loans to *private equity* Funds. There are hardly ever liquid Investments even involved (virtually by definition). This just seems to demonstrate confusion or a lack of understanding about the Subscription Facility market. If there is a default or maturity under a Subscription Facility, the required remedy or action is for the Fund to make a capital call on the Investors. No Fund would be forced to liquidate Investments unless the financial crisis was truly so severe that the Investors lacked the financial wherewithal to honor their own capital commitments. Third, a Subscription Facility does nothing to increase the likelihood of an Investor defaulting on a capital call. A Fund can, under the terms of virtually all limited partnership agreements, call 100% of an Investor's uncalled capital commitments at any time, even tomorrow. A Subscription Facility does nothing to change that. A Subscription Facility does not increase an Investor's funding obligation by a single dollar. Suggesting a Subscription Facility increases the likelihood of Investor defaults is unsupportable. An Investor irresponsibly managing its own liquidity is perhaps a real theoretical risk, but laying that at the door of the Subscription Facility market is misdirected. Rather, and ironically, Subscription Facilities allow Funds to better forecast upcoming capital calls, enabling Investors to better manage their own liquidity needs.

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8 <u>See</u>, Financial Times SCF Article ("Prof Phalippou agrees there will be a "huge cost" in the event of a financial crisis, as banks will demand their loans are repaid swiftly and private equity managers will face multiple urgent requests for cash. This could force fund managers to sell their liquid equity and bond holdings first, exacerbating market instability.")

It is of course theoretically possible that a financial crisis could become so severe that Investors experience liquidity challenges. If Investors were actually unable to fund capital calls as a result of illiquidity, it would of course be a bad result for Subscription Facility lenders. The lenders understand this; that is the risk they underwrite to every day. But how likely is this? How severe would a financial crisis have to be for this to occur? Implying that the Subscription Facility product poses "systemic risk" should not be casually stated; such an attention grabbing statement should be made with strong conviction based on evidence and real data. But the Article, like the press reports that pre-dated it, offers no data at all supporting the assertion. Given the three decade history and successful track record of Subscription Facilities, it is more than fair to ask for the evidence. An interesting data point would be what observations and experiences did PwC's private equity practice have during the recent financial crisis that might prove instructive for predicting outcomes in a future crisis? For example, in 2009-2012, did PwC see any Funds fail to repay a Subscription Facility or any lender take a loss on a Subscription Facility? Cadwalader did not. Not even one. Did PwC actually see, in all the Funds it provides tax and audit services to, any institutional Investor default on a capital call? How many? Out of how many capital calls? (Cadwalader saw none). And the recent financial crisis was awfully severe. To lead to wide spread Investor defaults on capital calls and ultimately losses for lenders on Subscription Facilities, clearly the severity of such a crisis would have to be significantly greater than what was recently experienced.

One way the private equity market has certainly evolved since the crisis is the growth of secondaries Funds. According to Preqin data, as of today there is $85+ billion dollars of dry powder in secondaries Funds, many multiples greater than what existed when the crisis commenced. Today, if an Investor faced liquidity challenges severe enough to threaten its ability to fund capital calls, there is a large, committed capital market poised to bid for Investor interests. This secondary market further reduces the likelihood that Investor defaults are likely to be an early crisis casualty in even a severe downturn.

Conclusion

PwC is a preeminent professional services firm. When they publish a thought leadership piece, markets rightly listen, bank regulators listen, Investors listen and the financial press quotes. PwC has an outstanding private equity practice; they have vast experience that we suspect could be extremely helpful and informative to the proper and rational evaluation of the Subscription Facility product and its implications for Funds and Investors. We suspect they have ample data and experience from the recent financial crisis that would weigh against the articulated concerns suggesting Subscription Facilities cause systemic risk and the other negatives repeated in the Article. We suspect, like us, they have seen virtually zero Subscription Facility defaults and incredibly few Investor delinquencies on capital calls – these forebearings of risk simply did not manifest in the recent crisis. We would invite PwC to bring its great wealth of experience to the Subscription Facility conversation.

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If you have any questions, please feel free to contact:

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